
Contract Closeout Audit of
Office of Educational Research and Improvement
Contract No. RJ96006501
At Northwest Regional Educational Laboratory



FINAL AUDIT REPORT
ED-OIG/A07-C0008
September 2002

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U.S. Department of Education
Office of Inspector General
Kansas City, Missouri Office

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SEP 1 2 2002

Dr. Carol F. Thomas
Executive Director
Northwest Regional Educational Laboratory (NWREL)
101 SW Main Street, Suite 500
Portland, OR 97204

Dear Dr. Thomas:

Enclosed is our report entitled *Contract Closeout Audit of Office of Educational Research and Improvement Contract No. RJ96006501 at Northwest Regional Educational Laboratory* (Control No. ED-OIG/A07-C0008). The report incorporates the comments you provided in response to the draft audit report. If you have any additional comments or information that you believe may have a bearing on the resolution of this audit, you should send them directly to the following Department of Education official, who will consider them before taking final Departmental action on the audit:

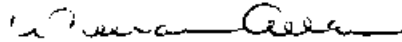
Mr. Jack Martin
Chief Financial Officer
U.S. Department of Education
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Office of Management and Budget Circular A-50 directs Federal agencies to expedite the resolution of audits by initiating timely action on the findings and recommendations contained therein. Therefore, receipt of your comments within 30 days would be greatly appreciated.

Page 2 - Dr. Thomas

In accordance with the Freedom of Information Act (5 U.S.C. §552), reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act.

Sincerely,

A handwritten signature in dark ink, appearing to read "William Allen", written in a cursive style.

William Allen
Regional Inspector General for Audit

Enclosure

**Contract Closeout Audit of
Office of Educational Research and Improvement
Contract No. RJ96006501
At Northwest Regional Educational Laboratory**

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**Contract Closeout Audit of
Office of Educational Research and Improvement
Contract No. RJ96006501
At Northwest Regional Educational Laboratory**

Executive Summary

We reviewed the Office of Educational Research and Improvement (OERI) contract held by Northwest Regional Educational Laboratory (NWREL) to determine the accuracy and reasonableness of costs incurred for products and services provided. Except as noted below and within the context of our scope of work described in the report, we found that the costs billed by NWREL were materially reasonable and accurate.

The Federal Acquisition Regulation limits the Government's payment obligation to an amount authorized in the contract or any subsequent modifications to the contract. The final modification on the contract limited the Department's payment obligation to \$29,836,858. NWREL billed the Department and received payments exceeding this amount by \$320,195.

NWREL did not ensure that all costs that should have been excluded from indirect costs were identified to prevent NWREL from claiming indirect costs on these amounts. Amounts on subcontracts exceeding \$25,000 were not always coded properly before they were entered into NWREL's accounting system.

As a result, NWREL improperly claimed indirect costs on amounts in excess of allowable limits, and understated amounts included in its indirect cost rate proposals submitted to the Department.

We recommend that the Chief Financial Officer (CFO) take action to ensure that NWREL refunds \$320,195 in overpayments, and no further payments are made without authorization. We also recommend that the CFO require NWREL to improve its internal controls over the processing of subcontracts to ensure that excess indirect costs are not claimed and, as appropriate, submit amended indirect cost rate proposals to the Indirect Cost Group (ICG), Office of the Chief Financial Officer (OCFO).

NWREL officials concurred with our recommendation to return amounts received in excess of the

contract authorization and have changed its cash receipts system to better identify deposits from the U.S. Treasury. However, they stated the overpayments occurred because they received advances in excess of the contract value, not as payments for amounts billed as stated in our finding. We agree that NWREL was operating under an advance payment system; however, contract payments into the advance account were generated based on NWREL's vouchers reporting contract expenditures. NWREL was also responsible for spending down the advance account at the close of the contract.

NWREL officials also indicated that indirect costs were improperly claimed on subcontracts over \$25,000, and corrective action had been taken to strengthen internal controls in this area.

Background

NWREL is a private, nonprofit corporation located in Portland, Oregon, and primarily serves the states of Alaska, Idaho, Montana, Oregon, and Washington. Its clients include five state education agencies, over 500 local school districts, 26 private and parochial schools, 34 intermediate and county education agencies, and 76 colleges and universities. In furtherance of its mission to improve educational results for children, youth, and adults by providing research and development assistance in delivering equitable, high quality educational programs, NWREL conducts six programs in research and development, and five in training and technical assistance. NWREL is funded through a variety of public and private sources including federal, state and local agencies, institutions of higher education, and businesses. Although each program has its own specific grants and contracts, the Lab's primary source of funding is through OERI.

Contract No. RJ96006501 is a cost-reimbursement plus fixed fee contract. OERI and the Contract and Purchasing Operations, OCFO were responsible for overseeing the contract. The period of performance of the contract was from December 11, 1995 - December 10, 2000, but extended through September 2001 for additional work. The following table summarizes the costs incurred and paid.

1.	Final award authorization		\$29,836,858
2.	Labor costs incurred	\$10,790,488	
3.	Other direct costs incurred	9,839,659	
4.	Indirect cost expense	8,474,723	
5.	Total contract costs reported on Job Summary Report		\$29,104,870
6.	Budgeted Fee	\$869,035	
7.	Amount actual costs incurred exceeded authorized ¹	137,047	
8.	Net Fee Earned		\$731,988
9.	Total contract costs plus fee		\$29,836,858
10.	Contract payments made through ED PMS	\$10,321,721	
11.	Contract payments made through EDCAPS	19,835,332	

¹ A fee adjustment of \$137,047 was made on the Job Summary Report; however, NWREL officials informed us that the amount the contract was overspent was actually \$139,995.

12. Total payments made against the contract	\$30,157,053
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Audit Results

Except as noted below and within the context of our scope of work described in the report, we found that the costs billed by NWREL were materially reasonable and accurate. NWREL needs to improve its management controls over accounting for contract costs billed to the Department because it violated the Federal Acquisition Regulation (FAR) when it failed to account for payments received that exceeded the authorized amount of the contract. In addition, NWREL improperly billed the Department for excess indirect costs claimed for subcontract amounts exceeding \$25,000, and understated its negotiated general and administrative expenses (G&A) indirect cost rate.

Finding No. 1 – NWREL Received Payments That Exceeded Authorized Amounts

NWREL billed for and received \$320,195 in excess of the authorized amount of the contract. NWREL billed the Department for amounts more than allowable limits because of errors in recording advances and payments in its accounting system. As a result, NWREL is liable for all payments received that exceeded the authorized amount.

The Government's Payment Obligation is Limited to Authorized Amounts

FAR 17.106-1(g) *Payment limit* states that:

The contracting officer shall limit the Government's payment obligation to an amount available for contract performance. The contracting officer shall insert the amount for the first program year in the contract upon award and modify it for successive program years upon availability of funds.

Contract Modification No. 24, dated September 13, 2001, limits the Government's payment obligation to \$29,836,858. NWREL's Job Summary Report (Appendix A) stated that the funded value of the

contract was \$29,836,858.

NWREL Billed the Government and Received Payment for Contract Costs That Exceeded Authorized Amounts

NWREL's job summary report identified total expenses incurred for the contract of \$29,836,858. This agreed with the amount authorized by the Contracting Officer on the final modification. After reviewing general ledger detail, vouchers, and departmental records, we determined that NWREL received payments totaling \$30,157,053, which is \$320,195 in excess of the authorization.

NWREL Failed To Properly Record Amounts In Its Accounting System Which Resulted In Overpayments Totaling \$320,195

NWREL's management controls did not ensure that contract invoices were properly recorded in its accounting system. Timely reconciliations were not completed to avoid billing and receiving payments in excess of authorized limits. NWREL informed us that:

[t]he effort to reconcile this was considerable . . . NWREL's system for recording cash receipts created difficulty in determining which entries were the original cash receipt and which entries were reclasses or transfers between accounts.

In February 1998, NWREL switched from the automated FEDWIRE method of payments which were made through the Department's (ED) Payment Management System (PMS) to the advanced payment method made through the Education Central Automated Processing System (EDCAPS), Contract Purchasing Support System (CPSS). EDPMS operated through April 24, 1998, when it was replaced by EDCAPS. During our review, we found the following examples of improperly recorded amounts.

- NWREL had submitted an invoice for an advanced payment amount of \$532,886 that was not recorded in its accounting system.
- NWREL had received payment for four invoices totaling \$74,733 that it did not record as revenue received.

Because NWREL failed to properly record these and other amounts in its accounting system, it received payments in excess of the authorized amount of the contract totaling \$320,195.

The Department failed to prevent the overpayments because during the system conversion it recorded the unliquidated obligations from PMS in EDCAPS before applying all the payments. Instead of identifying the overpayments to NWREL, the EDCAPS system showed an unexpended obligation in excess of \$1.9 million. According to NWREL's Director of Finance, the Department contributed to NWREL's reconciliation problems because payments made through EDCAPS were deposited in its general account rather than the account established for advanced payments (as mandated by the contract) which required NWREL to make additional entries to transfer the cash receipts. NWREL was not providing clear and consistent descriptions for these entries in its system.

Recommendations

The CFO should require NWREL to:

- 1.1 Develop policies and procedures to improve its system for accounting for billings, and contract payments and advances received.
- 1.2 Return payments totaling \$320,195 received in excess of authorized limits to the Department of Education.²

NWREL's Comments

NWREL concurred that the contract payments were difficult to reconcile because of problems with the Department's payment systems and NWREL's cash receipts system. Accordingly, NWREL has revised its cash receipts system to better identify deposits from the U.S. Treasury. In addition, NWREL emphasized that the payments were recorded in their system as advances, not as payments for amounts billed. They stated that all advances were recorded in their accounting system and the amount remaining was classified as a liability. The full text of NWREL's comments is included as Appendix B of this report.

OIG Response

We agree that NWREL was operating with an advance payment of \$1.8 million. However, contract payments into the advance account were generated based on NWREL's vouchers reporting contract expenditures. NWREL was also responsible for spending down the advance account at the close of the

contract. We did not determine all accounting misclassifications, but had noted that the above amounts were not recorded in the contract's revenue account. As stated in the report, NWREL indicated it had returned the contract overpayment to the Contracting Officer.

Finding No. 2 – NWREL Improperly Claimed Indirect Costs on Subcontracts Amounts Exceeding Allowable Limits, and Understated Amounts Included In Its Indirect Cost Rate Proposals

NWREL's management controls did not ensure that all costs that should have been excluded from indirect costs were identified to prevent NWREL from claiming indirect costs on these amounts. Amounts on subcontracts exceeding \$25,000 were not always coded properly before they were entered into NWREL's accounting system. As a result, NWREL improperly claimed indirect costs on amounts in excess of allowable limits, and understated amounts included on its indirect cost rate proposals submitted to the Department.

Office of Management and Budget (OMB) Circular A-122 Prescribes the Basis for Allocating Indirect Costs

Attachment A of the Final Revision of OMB Circular A-122, Cost Principles for Non-Profit Organizations, subparagraph C.1 defines indirect costs as "those that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective" (e.g., the contract). The Circular, at subparagraph D.3.f., describes the basis used to allocate indirect costs to a contract.

Indirect costs shall be distributed to applicable sponsored awards and other benefitting activities within each major function on the basis of [modified total direct costs] MTDC.

MTDC consists of all salaries and wages, fringe benefits, materials and supplies, services, travel, and subgrants and **subcontracts up to the first \$25,000** of each subgrant or subcontract (regardless of the period covered by the subgrant or subcontract) . . . the portion in excess of \$25,000 shall be excluded from MTDC.

[Emphasis added.]

² NWREL informed us on May 3, 2002, that it had sent the contracting officer a check for \$324,845.61. The amount reflected a preliminary determination of overpayment that was subsequently refined.

FAR 31.201-2(d) states that "[a] contractor is responsible for accounting for costs appropriately"

NWREL Claimed Excess Indirect Costs On Subcontracts, and Understated Amounts Included In Its Indirect Cost Rate Proposals

NWREL's Job Summary Report categorized \$9,839,659 as other *direct* costs (ODC) incurred and billed to the Department. We statistically selected a sample of ODC records and verified that the costs were supported and allowable. However, we found that NWREL improperly claimed *indirect* costs on subcontract amounts greater than \$25,000. In an attempt to identify the remaining subcontracts over \$25,000, we expanded our review to include 100 percent of all subcontractors included in the transactions identified as service contractors, and other services - subcontracts smaller/greater than \$25,000. (See the *Scope and Methodology Section* for additional information on sampling methodology.)

NWREL included a line item for subcontract amounts greater than \$25,000 in its indirect cost rate proposals submitted to the Department. Since NWREL did not always properly identify these amounts, this line item was also understated.

NWREL's Management Controls Did Not Ensure That Subcontract Costs Were Accounted for Appropriately

NWREL procedures relating to the processing of subcontracts were inadequate. NWREL had a written policy that subcontract amounts exceeding \$25,000 were to be coded to preclude claiming indirect costs. Purchasing officials informed us that they coded purchase orders in adherence to this policy. However, we found at least two instances of incorrect coding, and not all subcontracts were routed through the purchasing office.

Failing to Account For Costs Appropriately Resulted in NWREL Claiming \$16,346 in Excess Indirect Costs and Understating Amounts In Its Indirect Cost Rate Proposals Submitted To the Department

As a result of failing to properly code all subcontract costs exceeding \$25,000 before entering into its accounting system, NWREL improperly claimed G&A expenses on subcontract costs totaling \$71,970. We determined that NWREL improperly claimed \$16,346 in excess indirect costs (\$15,870 plus fee

of \$476)³ for those subcontract amounts exceeding \$25,000.

As a result of failing to properly code all subcontract costs exceeding \$25,000 before entering into its accounting system, NWREL understated these amounts on its indirect cost rate proposals. MTDC was overstated as the amounts on the proposals were used to reduce MTDC. Since MTDC are the denominator in the indirect cost rate, the negotiated G&A indirect cost rates may have been understated.

Recommendations

The CFO should require NWREL to:

- 2.1 Develop policies and procedures to ensure that subcontract amounts exceeding \$25,000 are coded properly to preclude improperly claiming indirect costs.⁴
- 2.2 Submit corrected indirect cost rate proposals to the Director, Financial Improvement and Post Audit Operations.

NWREL's Comments

NWREL stated that the amounts in question were not material to the contract or its indirect cost proposal. NWREL has taken corrective action to improve its internal controls in this area. The full text of NWREL's comments is included as Appendix B of this report.

OIG Response

As a result of NWREL's actual costs exceeding the authorized award amount, we are not requesting that NWREL refund the improperly claimed indirect costs. We are recommending that NWREL consult with the Director, Financial Improvement and Post Audit Operations, for determination of the effect on negotiated indirect cost rates.

³ As explained elsewhere in the report, NWREL's actual costs exceeded the authorized award amount by \$139,995. As a result, we are not requesting that it refund the improperly claimed indirect costs.

⁴ On March 19, 2002, NWREL informed us that "As a result of this review, we will be reviewing purchase order coding to ensure that it complies with our internal controls and we will add a new general ledger account to properly classify service contracts in excess of \$25,000."

Audit Objective, Scope, and Methodology

The objective of the audit was to determine whether costs claimed were incurred, allowable, and adequately supported. We focused our review on the following areas.

- Accumulating and Reporting Contract Costs
- High-risk Cost Categories
- Contract Payments

To accomplish our objective, we:

- Interviewed NWREL's management officials and staff, and reviewed written policies and procedures to gain an understanding of its system for accumulating and reporting contract costs.
- Reviewed Contract No.RJ96006501, including the statement of work.
- Reviewed the audit reports for the year ended August 31, 2001, prepared by NWREL's Independent Public Accountants.
- Reviewed an August 1998 performance report prepared by NWREL's Independent Public Accountant.
- Reviewed laws and regulations to gain an understanding of allowable costs.
- Traced vouchers and payment data from the Department's records to NWREL's general ledger detail to verify payments received.

We statistically selected a systematic random sample of 31 employees from a universe of 310 employees to verify employment. We statistically selected a random sample of 41 from a universe of 20,581 labor records--total labor costs incurred were \$10,790,488--and traced them to timesheets and labor rates contained in human resources records to verify time charged and labor rates. We stratified a universe of 26,382 ODC records--total costs incurred were \$9,839,659-- into populations according to risk, and statistically selected random samples containing a total of 86 records. We traced the records to supporting documentation to verify that costs claimed were incurred, allowable, and adequately supported. The following table summarizes the labor and ODC samples.

Transaction Description	Job Category On NWREL's Job Summary Report	Records in Sample	Number of Records in Population	Dollar Value In Population
Labor Costs	Direct Labor			\$10,790,488
Employees	Verified Employment	31	310	
Labor charges	Verified time & rates	41	20,581	
Independent Contractors	Service Contracts	10	640	\$ 1,021,518
Temporary Services	Service Contracts	10	1,284	\$ 517,726
Staff Travel	Travel & Transport	20	6,563	\$ 1,636,441
Other Travel	Travel & Transport	10	2,600	\$ 976,018
Subcontracts < \$25,000	Other Services	4	50	\$ 307,830
Conference Expenses	Other Services	10	1,689	\$ 665,996
Other Services – Other	Other Services	10	1,261	\$ 282,017
Other Supplies	Supplies and Materials	10	1,239	\$ 618,534
Subcontracts >= \$25,000	Expenses w/o IDC	2	16	\$ 133,205

We judgmentally selected 32 ODC/subcontract records and traced them to supporting documentation to verify G&A indirect costs claimed. We reviewed payroll tax and fringe benefit indirect cost rates to determine if they were reasonable.

NWREL chose to allocate indirect facility/occupancy expenses using a direct allocation method rather than an indirect cost rate. We reviewed one month's allocation of facility/occupancy (rent, telephone, and computer network) costs to verify that the allocation method was reasonable, and costs claimed as other direct costs were not also included in indirect costs.

We relied extensively on computer-processed data extracted by NWREL for use in analyzing costs billed to the contract. We tested the accuracy, authenticity, and completeness of the data by comparing source records to computer data, and comparing computer data to source records. Based on these tests and assessments, we concluded that data were sufficiently reliable to be used in meeting the audit's objective.

The audit covered the contract period December 11, 1995 - September 30, 2001. We performed

fieldwork on-site at NWREL's offices in Portland, Oregon, during the periods January 14-18, 2002, and January 28 - February 5, 2002. We conducted our exit conference with NWREL on April 30, 2002. We conducted the audit in accordance with government auditing standards appropriate to the scope of review described above.

Statement on Management Controls

As part of our review, we gained an understanding of NWREL's management control structure, as well as its policies, procedures, and practices applicable to the scope of the audit. Our purpose was to assess the level of control risk for determining the nature, extent, and timing of our substantive tests. We assessed the significant controls in the following categories:

- Direct Labor
- Other Direct Costs
- Indirect Costs

Because of inherent limitations, a study and evaluation made for the limited purpose described above would not necessarily disclose all material weaknesses in the management controls. However, our assessment disclosed management control weaknesses that adversely affected NWREL's ability to administer the contract effectively. These weaknesses included improperly claiming costs in excess of the authorized limit, and improperly claiming indirect costs on subcontract amounts over \$25,000. These weaknesses and their effects are fully discussed in the *Audit Results* section of this report.

Appendix A

NWREL's Job Summary Report
(Costs incurred by category, plus fee)

As of 12/31/01

This page was removed because it contains proprietary information.

Appendix B

NWREL's Response to the Draft Report



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(503) 275-9500

Writer's Direct Dial Number: 503.275.0698 Fax: 503.275.9708 Internet: affordit@nwrel.org

August 9, 2002

AUG 13 2002

William Allen
Regional Inspector for Audit
U.S. Department of Education
Office of Inspector General
10220 N. Executive Hills Blvd, Room 200
Kansas City, MO 64153

Reference: Contract Closeout Audit of OERI Contract No. RJ96006501 at NWREL –
Draft Audit Report

Dear Mr. Allen:

Response to Draft Audit Report Finding No. 1 – NWREL received payments that exceeded authorized amounts.

The effort to reconcile payments was considerable and included collaboration with the IG Auditors and the Department of Education contracts office. The reconciliation proved problematic for three primary reasons.

1. The Department of Education changed from the Fedwire system to an advance system in March 1998.
2. The Department of Education's ACH system has been unable to consistently accommodate depositing into multiple bank accounts.
3. NWREL's system for recording cash receipts did not accommodate determining which entries were the original cash receipt and which entries were reclasses or transfers between accounts, as a result of item 2 above.

Item 2 is still an issue. The Department of Education, as of July 2002, deposited reimbursements from another contract into the OERI advance account. Apparently, the Department of Education's ACH system is still unable to accommodate deposits into two bank accounts. Accordingly, NWREL has revised the way it describes cash receipts to better identify deposits from the U.S. Treasury when said deposits are not deposited into the correct bank account.

Additionally, I think it's important to note that since March 1998, NWREL has recorded the advance funds as an advance in its accounting system, and not as payments for amounts billed. Page 4 of the draft audit report states that, "NWREL Failed to Properly Record Amounts In Its Accounting System Which Resulted In Overpayments Totaling \$320,195." In fact, NWREL did properly record all amounts received in its accounting system. NWREL consistently recorded

William Allen
August 9, 2002
Page 2

payments from the Department of Education into the advance account and consistently drew funds from the advance account only as they were expended. The amount remaining in the advance account was properly classified as a liability.

Response to Draft Audit Finding No. 2 – Indirect Costs on Subcontracts in excess of \$25,000

With regard to the indirect costs on subcontracts in excess of \$25,000, please see the attached letter sent March 19th to Joan Morris. As the amounts in question are not material to this contract or our indirect cost proposal, we request that the audit findings be modified to reflect this. As stated in the attached letter, NWREL has established a new general ledger account to improve its internal controls in this area.

To summarize, NWREL did not claim costs in excess of the contract, but did receive advances in excess of the contract value. The excess funds were properly recorded as an advance and returned to the Department of Education upon final determination. NWREL has improved its descriptions of cash receipts to accommodate the Department of Education's requirement to maintain a separate bank account even though the Department's ACH system is still unable to accommodate multiple bank accounts. With respect to excess indirect costs being claimed on subcontracts in excess of \$25,000; NWREL has improved its review of Purchase Orders and established another general ledger account to capture service contract payments in excess of \$25,000.

NWREL appreciates the hard work of the IG office in conducting its audit and welcomes any suggestions for improvements to NWREL's system of internal controls for contract accounting.

Sincerely,



Carol Thomas, Ph.D.
Chief Executive Officer

Enc.: March 19, 2002 letter from NWREL to Joan Morris

c: Richard Alford, NWREL
Todd Massinger, Hoffman, Stewart & Schmidt, PC

RA/tls



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March 19, 2002

Joan Morris
US Department of Education
Office of Inspector General
10220 N. Executive Hills Blvd, 2nd floor
Kansas City, MO 64153-1367

Dear Joan:

NWREL has reviewed the service contract and subcontract transactions selected by the IG Audit on the OERI contract RJ96006501. The total of these transactions can be summarized as follows:

Service contract & Subcontract spending with IDC applied	\$323,290
Service contract & Subcontract spending with IDC excluded	<u>152,940</u>
Total IG Audit selected transactions	\$476,230

The selected transactions represent 14 unique agreements, each of which should have had only the first \$25,000 with IDC applied. Of these 14 unique agreements, four had excess IDC totaling \$8,093 and one had unclaimed IDC of \$5,129. This creates a net amount of \$2,964 of excess indirect applied to the OERI contract.

As this nearly \$30 million contract was overspent \$139,995, any proposed adjustment less than this amount would be offset by additional unclaimed expenses. Or to put another way, our total spending was less than one half of one percent over the total contract and the amount of excess indirect charged was 1/100th of a percent of the total contract.

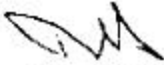
As these amounts are not material to either this contract or our audit thresholds, we would not recommend making adjustments unless you or our external auditor recommends so. As a result of this review, we will be reviewing purchase order coding to ensure that it complies with our internal controls and we will add a new general ledger account to properly classify service contracts in excess of \$25,000.

The enclosed material includes the original agreements as well as a summary of the agreements. Please contact me or Kathie Pratkan if you have any further questions regarding these transactions.

EQUAL OPPORTUNITY EMPLOYER

AUGUST 7, 2002

Sincerely,

A handwritten signature in black ink, appearing to read 'Richard Alford', with a stylized flourish at the end.

Richard Alford
Director of Finance

raa

Enclosure

Cc: Carol Thomas
Kathie Prakken
Michele Driscoll
Todd Massinger, Hoffman, Stewart & Schmidt, PC

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